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ECONOMICS FOR EXECUTIVES

**À SERIES OF TWENTY-FOUR
READING TEXTS WHICH CONSTI-
TUTE AN INTERPRETATION OF
THE UNDERLYING PRINCIPLES
OF ECONOMICS AND BUSINESS
FOR MEN AND WOMEN IN
PRACTICAL LIFE**

**EDITED BY
GEORGE E. ROBERTS**



**AMERICAN CHAMBER OF ECONOMICS
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READING TEXT XIV—ECONOMICS FOR EXECUTIVES

FOREIGN TRADE AND FOREIGN EXCHANGE

**EDITED BY
GEORGE E. ROBERTS**

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I

International Economics

TIME and again in the study of economic questions we are brought face to face with the fact that they are affected by conditions outside the boundaries of our own country. They are essentially international questions, because the world has become one economic unit.

The World an Economic Unit

Such basic matters as the volume of the country's production and the general level of its prices are vitally affected by conditions in the world market. No one can doubt, for instance, that the increase of 18 per cent in our production, which took place between 1913 and 1916, was occasioned chiefly by the increase in demand for American products on the part of the European countries then at war. The increase of 26 per cent in American prices which took place at the same time was also largely traceable

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to the same source. So, also, the fall in prices and in production which occurred three years after the war cannot be explained solely on the ground of happenings inside the United States. Our own economic life is a part of the economic life of the world.

This fact, brought home to the general public by the war, accounts for the growing interest in international economics which is now so widely reflected in the newspapers and magazines. The flood of published information about our exports and imports, about business conditions in foreign countries, and about the fluctuations in exchange rates on England, Germany, and other countries, has ceased to be of interest to foreign traders alone and has come to the attention of thousands of other business men. These men realize that important developments in the field of international business eventually affect their own concerns.

Misunderstandings Illustrated

The very recency of this wide popular interest has served to emphasize the misunderstanding with which international business transactions have long been commonly surrounded. Both the tendency of some people to underestimate the importance of foreign trade and the tendency of other people to overestimate this importance, have been ac-

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centuated. American loans to Europe, as a means of increasing our foreign trade, have been approved in some quarters and disapproved in others for reasons of the most superficial character. The suggestion that foreign loans should be floated here only on condition that the proceeds be spent here is a specific example of the confusion sometimes found in high places. An understanding of how international trade takes place, why it takes place, and how it is financed, is needed by anyone who wishes to see the real meaning of such proposals and to comprehend their practical significance.

Ignorance and Speculation

The movement of the foreign exchanges has also been subject to special misconception. Speculation in "marks," for instance, has been undertaken by people who scarcely know what "marks" are and who know nothing at all about what causes their price to move upward or downward. How such fluctuations may be prevented, and indeed whether their prevention would be in the public interest, are questions of no mere academic interest. A better popular understanding of the principles, practices, and problems of foreign trade and of foreign exchange was never so much needed as at the present time. Fortunately, such an under-

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standing is not difficult to acquire, provided attention is focused on the essentials.

The economics of international trade naturally belongs to the general subject of Exchange, to which the four preceding study-units, dealing with prices, money, and bank credit, are related, and to which the next two study-units, concerned with the general movement of prices and with commercial crises, also relate. Yet it should not be forgotten that the whole discussion of the process of exchange also throws light upon the principles of production. In fact, the study of production and the study of exchange both concern themselves with the same thing—with the way in which the world gets its living and achieves a state of general prosperity. We shall bear this idea in mind in the present discussion.

II

Principles Governing International Trade

All trade, as we have already had frequent occasion to note, consists at bottom of the exchange of products. Trade across national boundaries is of essentially the same nature as trade between different communi-

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ties within a single nation, and is consequently subject to the same general principles. There are three principles which we now propose to consider in order. The first is known as "Say's Law," the second is the "Principle of Reciprocity," and the third is the "Law of Comparative Costs."

Say's Law

Say's Law, like the other principles just mentioned, applies to all trade, both that between parts of the same country and that between different countries, but it is of special significance in the field of international trade. This law may be briefly stated as follows: *the total volume of trade depends upon the total volume of production*. This is true because every kind of goods that is brought to market not only adds to the supply of its own kind of goods, but confers upon its owner the purchasing power necessary for taking off the market every other kind of goods. According to this principle, there is but one way by which the volume of the world's trade can be substantially increased, and that is by increasing the volume of the world's production.

This principle might appear to be almost self-evident, but experience shows that this is by no means the case. Thus we hear of the tremendous advantages to accrue to the

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United States from trade with South America. These will no doubt be substantial, but unless and until the productive powers of South America are developed so that its people have more goods to sell, and consequently have more purchasing power to employ in the world's markets, the South American trade must be of much less importance to us than the trade of other regions, such as that of Europe. The reason is that Europe is a much more abundant producer of goods. She can buy more because she has more to sell.

The Importance of Russia's Trade

In a similar way, we have recently heard considerable emphasis placed on the importance of the world's trade with Russia, yet this trade amounted to but approximately 3 per cent of the world's total before the war—that is, before the recent great reduction in the producing power of Russia. When that power is restored, and still more when it grows up to the possibilities of a territory so vast and so rich in natural resources, then Russia will be a large producer and her trade will for that reason be abundantly worth while. It may be said in general that the slump in the world's production which followed the war must be overcome before the total volume of international

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trade can be expected to show expansion to any marked degree.

Principle of Reciprocity

The Principle of Reciprocity is even more commonly overlooked than Say's Law. According to this principle *the exports of a nation pay for its imports, its imports are paid for by its exports, and the two must in the long run be equal.*

A nation cannot long continue to buy abroad unless it also sells abroad. Neither can it sell abroad continuously unless it also buys abroad. It should be observed that the principle of reciprocity, as here set forth, is of economic character and has no direct relation to the so-called "policy of reciprocity," such as that which led the United States, under President Taft's administration, to suggest to Canada that we would reduce certain customs duties against her if she would in turn reduce certain duties against us. The principle of reciprocity is an economic principle, not a political one.

Imports and the Principle

All discussion which looks to expansion of our exports without allowing for an equivalent expansion of our imports, ignores the principle of reciprocity. The one-sided view, which puts all the emphasis on exports,

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seems to be based on the fallacy that international trade consists of the sale of goods for money and that it is desirable to have money flowing into the country.

This view arises from the fact that goods are priced in money and payments are made in terms of money, although in international trade as in domestic trade, the function of money is merely to facilitate the exchange of commodities and services. Gold is the money of international trade, but the gold reserves of most countries are insignificant compared with the amount of their foreign trade. International trade would be reduced to very small proportions if every purchase had to be paid for by a shipment of gold. Gold reserves may be drawn upon in the course of trade for the settlement of balances which run alternately one way and the other, but no nation will allow its gold reserves to be exhausted or even seriously depleted because they are the basis of its monetary, banking, and credit system. If a country's international balances are so heavily against it as to threaten its gold reserves it will put an embargo upon gold exports, and let trade adapt itself to the condition as best it may. We have seen all countries do this in recent years, even the United States adopting the policy while we were at war.

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Necessity for Imports

In any comprehensive consideration of export business, therefore, it is necessary to give consideration to imports and recognize the necessity for them. If a country wishes to sell abroad it must give some thought to the ability of other countries to make payment, for they cannot pay without its help. The purchasing power of every country is in its own powers of production. True, immediate payment may be obviated by granting credit, either directly or by the transfer of securities, but this means nothing but a postponement of payment. Eventually settlement must be made, and in the form of goods or services produced.

In active practice comparatively little gold actually moves from one country to another, because of the efficiency of the international banking system and the settlement of balances by offsetting credits of one sort or another. This point will become clearer after we have considered how international payments are effected, which we shall do in a later section of this study-unit. From that examination, indeed, it will become evident that foreign trade and foreign exchange are for the most part merely different aspects of the same thing, and an understanding of each in its important aspects, helps to bring about

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a more useful and more comprehensive understanding of the other.

Law of Comparative Costs

We now come to consider the Law of Comparative Costs. This is far the most important of the three principles governing international trade and is at the same time the most generally overlooked. There is, however, nothing especially mysterious about it, and careful consideration will show that it is quite in line with the view of trade which recommends itself readily to common sense when only domestic trade is under consideration. The importance of considering this law in some detail is that it explains why people of different nations trade with one another at all, why they export certain commodities instead of others, why their imports take the forms that they do, and, in general, why the advantages of international trade are substantial and its alleged disadvantages are mainly illusory.

We shall first give a brief statement of the law, recognizing that its full meaning will only be evident after considerable analysis and illustration. Both the name of the law and its statement make use of the term "costs," not in the sense of money costs, as might be supposed, but in the sense of "real" costs, which are the outlay of labor,

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waiting, and the like. The law runs as follows: *trade between two nations is of advantage to both, and trade among several nations is of advantage to all, when the comparative real costs of producing the commodities exchanged are not the same everywhere.* The implication is that a country pursues its advantage when it exports commodities which are comparatively easy to produce within its own boundaries, and imports commodities in exchange that are relatively difficult for it to produce.

A country's foreign trade generally conforms to this law in a very obvious way. Exports usually consist of natural products, or of manufactures for which there is a readily available supply of raw materials, or for which the country is peculiarly adapted by the state of its industrial development. Imports, for like reasons, consist of products more easily produced in other countries.

Trade of the United States

The trade of the United States has been mainly of this kind. In 1914, for example, our leading items of export were breadstuffs, cotton, provisions, iron and steel and goods manufactured from iron and steel, petroleum, and copper. The reader will immediately recognize these as the articles which America is able to produce with compara-

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tive case. The right combination of natural resources, labor, and capital occur here to make us the leaders in these fields of production. We can produce the articles in quantity cheaper than can other countries.

Goods imported consisted of raw materials for manufacture, food, manufactured goods, and luxuries. Among the foods imported were sugar, coffee, tropical fruits, nuts, and tea. The raw materials imported were chiefly sisal grass, manila hemp, jute, flax, wool, hides, and raw rubber. These articles are the ones which we either do not produce at all, or do not produce in an adequate supply. Manufactures imported were earthenware, china, glass, jewelry, clocks, works of art, books, matting, manufactured furs, and many other similar articles. These are the articles upon which foreign countries have long specialized and which they can produce more advantageously than can we because of their inherited taste and skill and exceptional natural resources.

Exceptions and the Law

There are exceptions, however, to this class of trade, and it is in explaining these exceptions that we have special need for the law of comparative costs. Imports do not always consist of articles which the importing nation cannot readily produce at

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home. Among the imports of any nation will be found articles for whose production it has even better facilities than those of the country from which the imports come. The importation of hemp into the United States is an example of this situation. No doubt our land is as fertile as the lands in Italy and Russia from which we import hemp, and our labor is more efficient than theirs. Flax and linen furnish another example. In spite of a tariff duty on flax and linen, we still import most of our supply of these two articles, yet we could doubtless produce them as efficiently as Ireland or Germany. We could produce both more flax per acre and more per man. Is it economy, then, for us to import rather than produce these articles?

Individuals and Countries

The answer to these questions will become evident if we give a little examination to an analogous situation which involves two or more individuals instead of two or more nations. Many heads of business organizations, for example, are better accountants, or advertising men, or correspondents than are the men whom they employ in these capacities, but it does not pay heads of businesses to serve in these capacities. The head of a business cannot do all the work

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of managing and at the same time perform all these other duties as well; he therefore chooses among the various activities in which he excels and naturally confines himself to the ones in which he excels most. He hires accountants, advertising men, and correspondents that may be less efficient than himself in order to release his own energies for the work in which he has a greater advantage. The limitations on his time and energy impel him to choose this course.

So it is in cases of international trade like the ones we have mentioned. Sometimes one country will import an article which it could produce more economically than can the country from which it imports, but the superior advantage which it enjoys in producing other articles justifies the practice. We continue to import hemp from Italy and Russia, and flax and linen from Ireland and Germany, not because we cannot produce them as efficiently as these countries, but because we cannot turn our attention to them without curtailing the production of *other* articles in which we have a *still greater advantage*. The land and the farm help which we would have to devote to the production of flax or hemp yields us much better returns if we plant and till corn, or wheat, or oats, or tobacco, or cotton. We gain by continuing to produce wheat, steel, cotton cloth, and the

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like, and by exchanging these for flax, hemp, linen, and the things we import.

Where the Advantages Lie

Sometimes a country's advantage lies in the possession of more skilled labor than is possessed by other countries. Sometimes its advantage is due to a greater supply of capital, or to more alert and progressive management, or to more abundant natural resources. But more often it is due to a combination of these factors. America and Canada export wheat, for example, partly because farm labor in these two countries is highly intelligent and skilled, but more particularly because of the fertility of the land, the favorable climatic conditions, improved farm machinery, and cheap transportation. The superiority of these two countries in producing wheat grows out of the combination of advantages.

The fact that a country tends to export those goods which it can produce comparatively cheaply has led such countries as the United States and England, where wages are high, to fear the exports of countries in which wages are low. Many people in these two countries profess constant apprehension of floods of goods made with the cheap labor of Japan and Germany. But an understanding of the facts dispels this fear.

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Those who entertain this fear lay undue emphasis upon labor as a factor in production. As we have shown in the study-unit on the factors of production, society does not produce by labor alone. And it does not trade on the advantages of labor alone. Goods that are produced at a cost low enough to permit them to compete favorably in foreign markets, require an economical combination of all the factors in production—of land and natural resources, labor, capital, and enterprise. Labor is but one of the factors and the advantage of low labor costs alone is hardly of enough strength to offset disadvantages in the other three factors, and to cause goods to move into world markets.

Low Wages and Labor Costs

But even if low labor costs are sufficient to cause goods to be exported, it should be understood that *low wages* do not invariably result in *low labor costs*. Labor costs are high or low accordingly as labor is more or less productive and high wages frequently mean relatively low labor costs and low prices. Japanese labor is paid low wages because in general it is inefficient labor and does not produce values that permit higher wages. This should dispel any fears that Japanese products will drive American goods from world markets.

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There is a still more fundamental reason why countries like England and the United States need have no fear of the export trade of countries like Japan. This reason involves reference to the principle of reciprocity which we have already considered. No country can export unless it also imports, a rule that applies to low-wage countries as well as to all others. Japan must buy as well as sell. She wishes to sell abroad as a means of obtaining the products of other countries.

"One-Sided Trade" Impossible

The advantage Japan may have in producing certain kinds of commodities may give her a dominant place in the world's trade in respect to these particular commodities. Other countries may consequently have to give up these lines in whole or in part. But this result means merely that the test of competition favors Japan in certain directions, while favoring other countries in still other directions. Since Japan can continue to sell merchandise only on condition that she also buys merchandise, the countries which sell to her will find among her people a market for exports. This consideration, which should be almost self-evident, makes it clear that there is no danger of low-wage countries, like Japan and China, driving

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high-wage countries, like the United States and England, out of *all* lines of business.

Fears Without Foundation

Fears that any one country or several countries may do all the work of the world are without foundation. The amount of work that any people, or all peoples, can do is limited, and we have seen in other studies that there is literally no limit to the amount of work that may be done to satisfy human wants. The increased production of the more advanced countries which has come about during the last one hundred years from utilization of power and machinery, has been much more than the total production of all Asia, yet it has not come anywhere near to satisfying the wants of the population of these more advanced countries. (There is no danger of over-production, and, therefore, no danger that any country will be driven out of all kinds of industry.)

The problem of international competition, like the general problem presented by a competitive state of society, is that of distributing the population in such manner through the various industries and occupations, that the various products and services will be in proper balance and so be readily exchanged. It would be impossible for Japan, China, or any other country to overwhelm other coun-

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tries with its products without taking anything in return. No people would want to give up their products without getting something in return for them, and, as we have seen, other peoples have practically nothing to give but their own products and services. A great one-sided trade in the very nature of "trade" is impossible.

A Different Situation

Thus far we have given consideration mainly to articles which a country obtains solely by trading with other countries. But there are many articles which are obtained partly by import and partly by home production. In the United States, for example, we export raw cotton and we import raw cotton; we import wool and we grow wool. How are these facts to be explained in view of the principles which we have laid down?

In many cases the foreign article differs so much from the domestic in grade or quality as to be virtually a different commodity. The cotton we import into the United States, for instance, is of two classes: exceptionally long fibre, coming mainly from Egypt, and a rough fibre from Peru and Bolivia. Both differ very materially from the great bulk of the product of the United States. Long-fibre cotton is used in manufacturing automobile tires and for other materials where

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great strength is desired, while rough-fibre cotton is used for mixing with wool. Until these are produced in sufficient quantities in the United States, as long-staple cotton is now coming to be, they are for all practical purposes different articles from the domestic product.

The Case of Wool

The wool we import, on the other hand, is to a great extent of the same quality as the domestic product, and this is often used as an illustration of an industry which should be encouraged in this country by tariffs. If it is good for the country to produce a part of its wool at home, would it not be equally advantageous to produce at home all the wool that we need?

This question might be answered in the affirmative if additional wool could be produced in this country without substantial increase in cost, but the fact that a goodly amount of wool is produced even in the face of foreign competition does not mean that any great increase in the supply of domestic wool would be forthcoming except at considerably higher cost. Wool is an agricultural product and as such it is produced under the law of diminishing returns which we explained in the study-unit on "The Primary Industries." Some land in the United States

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is well adapted to wool-growing. This land is as efficient for the production of wool as any land in the world, and wool grown upon it pays satisfactory returns at the price at which the imported product can be brought in. There will always be in the country, therefore, some profitable production of wool, but the supply will not be adequate. More domestic production will be forthcoming only by resort to other lands which are already more profitably employed for other products. If wool is to come from these acres it must be at a price which will make it advantageous for the owners to shift to wool-growing. Rather than pay an added price for wool necessary to permit this, it is better for the nation that the best sheep-grazing land be devoted to wool, that the best corn land be devoted to corn, the best wheat land to wheat, and so on. If it pays better to raise hogs than sheep we should grow hogs. The deficiency in wool can be more cheaply made up through imports for which we pay with our exports of wheat, cotton, meats, manufactures, and the like.

Summary

We may now sum up our discussion of the principles which govern international trade:

By means of foreign trade each nation is enabled to specialize in the products it can

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produce to greatest advantage. Its capital, its labor, and its natural resources are all devoted to the industries in which their combined results show efficiency. By specialization and concentration of industry, production becomes cheaper all round, that is, in all the nations concerned. This, of course, results in greater production, hence a better scale of living for all classes of society everywhere. The social gain, however, is not primarily in the exporting, as is so commonly supposed, but rather in the importing. The exports must be viewed socially as the cost of the imports. The imports, either by consumption or as a means of increasing production, contribute to the welfare of the people. They are the real gain from foreign trade.

This gain accrues because foreign trade enables a community to obtain the imported commodities on easier terms than if it tried to produce them itself.

Fundamentals Misunderstood

The analysis of international trade which we have just made deals with fundamentals, with merchandise imports and merchandise exports, with production and consumption. Both the method employed and the results of the analysis have for more than a hundred years been considered by economists to be

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of unquestioned validity. Yet the reception of these results by the general public has not been widespread, chiefly, it is believed, because of the very fact that they do rest on fundamental considerations and so seem to ignore the more superficial factors which impress the average person.

Thus the discussion of international trade in terms of effort and satisfaction, or in terms of real costs and real benefits, seems to ignore the superficial fact that trade is carried on in terms of money, yet everybody knows that the exporter of steel, for instance, does not take his pay in coffee, or in hemp, or in any other of our merchandise imports. There was a time when merchant traders owned their own ships and, filling them with domestic products, would start out on a trip, literally trading from port to port around the world and bringing home a cargo of foreign products for sale in the home market, but the development of international banking has changed all this. The exporter now sells his products in a foreign market in terms of money, draws a bill of exchange for the sum involved, discounts the bill with his banker, gets immediate credit for it in his account, and needs give no further thought to the transaction. He may not realize that the bill is offset and settled in the clearings by a similar draft drawn for

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the sale of foreign goods in this country, and that each transaction is just as much dependent upon the other as in the old days when the same merchant handled both exports and imports, but such in fact is the case.

In order to take account of the modern methods of trade, we must consider the means by which payments are made between countries, and how these payments are related to the movements of trade. This introduces the subject of foreign exchange.

III

The Mechanism of Foreign Exchange

Trading in foreign exchange may be defined as the business of buying and selling orders to pay foreign money at a foreign point. Such orders are called bills of exchange, or simply "foreign exchange" and they constitute "exchange material." Many people have the idea that the purchase and sale of foreign exchange means the purchase and sale of actual foreign money. This is not the case. We ordinarily speak of buying francs or pounds sterling, but what we actually buy is generally a bill of exchange payable in francs or pounds sterling. Eng-

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lish pounds sterling may be quoted in New York at \$3.75 per pound, but this is not a quotation for English sovereigns or bank notes; it is a quotation for drafts or bills of exchange drawn payable in English money in London.

Significance to the Business Man

Each day in a market like New York there are millions of dollars worth of these bills of exchange passing from hand to hand. The foreign exchange rates established by these transactions are barometers of foreign trade and also of international business conditions, which makes these rates of significance to every business man. The prices of great staples, such as wheat and cotton and coal and oil and steel products, are fixed in a world market, and he who would know markets and prices must make a study of foreign exchange rates. When exchange rates advance, our commodity markets also tend to advance and when exchange falls our markets are likely to follow.

On October 11, 1921, for example, the *New York Times* carried the announcement that an advance of 16 cents in sterling exchange over about a ten-day period had added 4½ cents a bushel to the value of the American wheat crop. Assuming the rise in sterling to be permanent, this meant

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that with a crop of 754,000,000 bushels, the gain to the American farmer was \$33,930,000 in the aggregate. And this is irrespective of whether a given farmer's wheat is eventually sold to a mill here or a mill abroad, for the price the domestic miller must pay is the price set by the foreign consumer, bidding in a world market.

In the foregoing calculation, however, the entire gain from the rise of British exchange is assumed to have accrued to the seller, although it may have accrued to the British buyer, or been divided between the two, as determined by competitive conditions in world markets. Exchange fluctuations are an element of uncertainty, costly to both buyers and sellers.)

How Bills of Exchange Arise

The significance of these bills of exchange can also be made apparent by considering how they come into being. The majority arises from trade between our people and those in foreign countries. Let us suppose that an American merchant has purchased men's clothing in England. His debt amounts to £300. How is he going to make payment? If he owed a clothing factory in Rochester, New York, he would simply draw his check for a certain number of dollars and send it on. But an English manufac-

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turer cannot spend dollars in England, hence he would have no use for an American check. He wants pounds sterling. The American merchant probably has no deposit in an English bank against which he can draw a check in sterling. The larger American banks, however, do keep such deposits, and so, to make his payment, the merchant goes to one of these banks or to one of its correspondents and buys a check or order drawn in sterling against the bank's London balance. This he then sends to his London creditor and the debt is settled. In selling sterling exchange the banker has sold his draft, drawn payable in sterling in London.

What Creates a Foreign Balance?

But how does the American bank obtain this balance in London against which it draws? It is apparent that it can no more draw against its account continuously without making deposits than an individual bank depositor can draw against his own account without making deposits. Overdrafts would soon be created.

The banker builds up his sterling balances by buying up claims which Americans hold against Englishmen. Let us suppose an American exporter has shipped cotton to England amounting to £1000. He will likely obtain settlement by drawing a draft

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for £1000 against the buyer, much as in domestic business we sometimes draw an "arrival draft" with an "order bill of lading" attached. This sterling draft he will sell to his banker for dollars. The banker sends it to his London correspondent for deposit just as the individual sends checks to his local bank for deposit. A balance is thus built up against which the American bank can sell drafts.

Banks as Middlemen

These illustrations make clear the position of banks in foreign exchange business. The banks act as middlemen. They buy up the claims of those who have foreign claims to collect and sell checks to those who have payments to make abroad. The banker's service consists in being constantly in readiness to buy all foreign bills offered and to sell to all who need to make payments abroad. Banks do not ordinarily create exchange, although occasionally they use their credit to bridge over a temporary scarcity of bills in the market, when there is reason to believe that a greater supply will be forthcoming in the near future. We shall refer to this practice later.

The banker's profit from dealings in exchange is a merchandising profit purely and simply. Just as the retail merchant buys

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coffee at one price and sells it at a higher price, so the banker buys pounds sterling at a certain price and sells them at a higher price. The profit comes from the volume of the transactions and the rapidity of the turnover rather than from the rate made on any single transaction.

The difference between the buying and selling rates for sterling bills of the same maturity is generally about one cent, frequently less. With sterling selling as low as \$3.50, the banker's margin of profit on each transaction is at the rate of less than $\frac{1}{8}$ of 1 per cent. In view of the small margin between buying and selling rates, therefore, there is no business in the world where a large volume and a rapid turnover is more essential to satisfactory profits.

Buying Rates vs. Selling Rates

We have explained why the bank's buying rate differs from the selling rate. Any other differences that may exist in exchange rates are matters of interest on the amount of money involved and to understand these it will be necessary for us to examine the published quotations for exchange in some detail. Because the rate for sterling exchange is quoted in a more complete form we choose that rate for purposes of illustration. The rates for sterling exchange, as published in

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the New York *Evening Post*, Monday,
August 8, 1921, were as follows:

Demand	3.71
Cables	3.71½
Bank 60 days	3.67
Bank 90 days	3.66
Coml 60 days	3.66
Coml 90 days	3.65

The first four of these quotations are selling rates for bills drawn by bankers. They are rates at which American banks are selling their own orders drawn upon English bankers. The last two are the buying rates. They are the rates which bankers are paying for bills drawn upon foreign concerns by American exporters and others having claims abroad to collect. A glance at the table shows that the highest rate is the rate for cables. Bankers are selling demand exchange to their customers for \$3.71 while they are getting ½ cent per pound more for cable transfers. Why this discrepancy?

A banker must charge more for a cable order than for demand exchange because, when selling cables, he does not have use of the funds involved. He receives his pay today from the buyer, cables ordering payment to be made abroad, and as soon as his message is received abroad, an equivalent amount is paid from his account. Thus the cable rate is a pure rate of exchange without

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the element of time entering into the transaction. The cable rate for sterling represents the value in New York of a pound sterling for immediate delivery in London.

Demand Exchange

The demand exchange quotation is for bankers' checks payable when presented abroad. The banker can afford to sell demand drafts cheaper than cables because he has the use of the funds while the draft is in transit. Let us suppose, for example, that an importer purchases a demand draft for £10,000 from his banker on August 8, paying the quoted rate of \$3.71 for it. The banker receives \$37,100. The purchaser mails the draft to his creditor abroad and his creditor presents it for payment at the bank upon which it is drawn, a matter that, allowing for mail time and for average delays, requires ten days or longer. During this time the American banker's foreign balance will be undisturbed so far as this draft is concerned and he will have the use of the funds. The use of funds for ten days is worth something. Suppose the rate for money to be about 5 per cent, as was the case at the time under consideration. The banker could obtain for the use of these funds, if he loaned them at 5 per cent for ten days, about \$50, which corresponds to

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the difference between the cable rate and the demand rate (\$37,150—\$37,100).

Sixty-day Bankers' Bills

The quotation for sixty-day bankers' bills is a quotation for drafts payable at sixty days sight, drawn by American bankers upon foreign bankers, and ninety-day bills are similar bills payable at ninety days sight. These of course the American banker can afford to sell correspondingly cheaper than demand exchange because of the longer time involved. In selling such bills the banker has the use of the amount involved for sixty or ninety days as compared with ten days when demand exchange is sold. The longer the time the lower the rate charged.

When we turn to the buying rate for commercial bills we find similar differences due to time involved. Reference to the table shows that the banker is paying at the rate of \$3.66 per pound for sixty-day bills while he is paying one cent less for ninety-day bills. This difference is due to the fact that a banker who buys sixty-day sterling bills, giving the customer cash for them, has to wait at least sixty days to get his money back, while if he buys ninety-day bills, he has to wait ninety days. He therefore pays less for the ninety-day bills, the difference corresponding to the interest at the current rate

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for the additional time involved. The principle is exactly the same as when a bank discounts a note. The longer the period which the note has to run, the less the bank can afford to give for it.

These considerations explain why the quotations for different types of bills differ at any given time; but we have fluctuations from day to day in the quotations for the same kind of exchange and we must now turn to an explanation of these differences. Such an explanation calls for an understanding of the factors which influence the market for foreign exchange and for a comprehension of how these factors work together.

IV

The Market for Foreign Exchange

On August 8, 1921, demand sterling was quoted at 3.71, as we have shown. The next day the price dropped to $3.66\frac{1}{2}$, and a week before it was quoted at $3.56\frac{1}{4}$; a little over two months later it was quoted at $3.85\frac{1}{2}$, and soon thereafter at 4.00. In 1920 the highest price was $4.06\frac{3}{4}$ and the lowest 3.18; in 1919 the highest $4.75\frac{7}{8}$, the lowest $3.65\frac{1}{4}$; just after the war broke out in 1914, sterling was as high as \$7.00.

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How are such fluctuations in the prices of exchange to be explained?

The answer to this question is simply that the price of foreign exchange fluctuates with demand and supply just as does the price of any commodity, such as cotton or wheat. If there is a heavy supply of foreign bills of a certain currency offered in the New York market, and there are relatively few asking for such bills, the rate of exchange will be low. If, on the other hand, the demand is heavy or the supply light, the exchange rate will be high.

The supply of exchange on the one hand and the demand for it on the other originate from a variety of sources. These sources must now be analyzed in order that we may discover what underlying factors tend to increase or decrease the supply of exchange and what ones tend to increase or decrease the demand for it. Such an inquiry is of the nature of a "market analysis," similar to that made of commodity markets by business men, speculators, and other persons who want to be in position to anticipate the trend which the market may be expected to take in the future.

"Dollar Exchange" in London

It will make for clarity in this discussion if we change the point of view from which

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we have been considering exchange material. Thus far we have been viewing the New York market for the various kinds of exchange on foreign countries, such as England, France, and Germany. Let us now take our stand in a foreign market, such as London, where there is trading in bills of exchange on the United States, drawn in dollars. If we consider how the "dollar" fluctuates in value in the exchange markets of the world, we shall be able to see the forces at work more clearly than if we should take sterling for our example, because we shall have to consider such matters as exports and imports, and we are naturally more familiar with our own exports and imports than with those of other countries.

We must remember, in this connection, that dollar exchange in foreign markets moves in opposite directions from foreign exchange in our own market. If sterling drafts, for example, are cheap in New York, dollar drafts will be high in London. This is true because a creditor in New York who has a London debtor has two alternative methods of receiving his pay. He may draw *a draft in pounds sterling* upon his debtor and sell it in New York at the current rate for sterling drafts, or he may have his debtor purchase a *dollar draft* in London and send it to him. The foreign exchange market is

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tied together by cable, and if it should ever happen that sterling drafts were relatively low in New York and dollars were relatively low at the same time in London, no American creditor would draw sterling drafts on his English debtor and sell them in New York. Rather he would have the debtor buy dollars in London and remit. This would keep on until the demand for dollar drafts in London became so acute as to force rates to an equilibrium in London. Every factor that causes one country to receive payments from another tends to lift the former's exchange in all markets, and payments it has to make abroad depress its exchange.

Trade and Exchange

Chief among the items ordinarily affecting the rate of exchange is foreign trade. We have already seen how exports from the United States to England bring into being a supply of sterling exchange and how imports bring into being a demand for it. The ebb and flow of trade, therefore, is always affecting the exchange market. This is true not only in ordinary times, when the trading countries are on a gold basis, but even in extraordinary times, like those of the present, when the fluctuating values of foreign paper currencies introduce complicating factors into the situation.

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Exports from the United States tend to raise the rate of dollar exchange. This is true because every time a shipment of goods leaves the United States someone abroad has to provide dollars in payment. In other words the demand for dollars has been increased and the natural effect of an increase in the demand for a commodity is to raise its price.

Effect of Exports

The effect of exports has been particularly noticeable in the fluctuations of the rates of exchange between the United States and European countries. In normal times our exports to Europe have been seasonal. Every year in the fall and winter heavy exports of the new crops of grain and cotton have gone forward. These movements annually bring a flood of foreign bills into the New York market which depresses European exchange here and raises the price of the dollar abroad. Experts in foreign exchange have come, therefore, to look for a periodical downward dip of foreign exchange rates in New York in the fall and early winter and an upward swing in quotations for the dollar in foreign markets.

The effect of imports into this country is exactly opposite to that of exports. Imports tend to depress the rates at which dollars

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sell abroad. Every time someone abroad sells goods in America he receives a claim for dollars. For these dollars he usually has no use. He sells his claim and buys the exchange of his own country. This brings into the market an added supply of dollars, the effect of which is to depress the market for dollars.

Imports Less Seasonal

Imports have usually been less seasonal than exports. They have consisted largely of finished manufactured goods which are not produced in conformity with the seasons. But there are instances where the exchanges have been heavily disturbed by movements of imports. Such an instance occurred in 1909, just prior to an upward revision of the tariff. At this time it was practically a certainty that tariffs would be raised, hence there was a rush to get goods into America before the new schedules went into effect. The result was an exceedingly high rate of foreign exchange in New York, and this in spite of the fact that it was the season of heavy exports and normally lowest rates for the year.

Security Movements

Movements of securities have an effect upon the exchanges similar to that of move-

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ments of goods. Prior to the war the English, the French, and the Germans were large buyers of American stocks and bonds listed on the New York Stock Exchange. The payments they made for these securities had the effect of holding up the value of the dollar in their markets. If Paris bankers, for example, buy stocks or bonds on the New York Stock Exchange for their clients, they will have to buy dollar drafts in Paris to send over to New York in payment, or if they do not do this, the American sellers will draw franc drafts on them and sell these franc drafts in New York. The result will be an increased demand for dollars in Paris and higher rates for the dollar, or an increased supply of franc exchange in New York and lower rates for the franc. If American investors buy securities in such markets as London and Paris, or French and English investors sell their holdings in the New York market, as they have been doing since the war, the effect is just the opposite. Dollars will tend to fall and foreign exchange in New York will tend to rise.

For a long time following the outbreak of the war, it was a source of wonder to many that the price of sterling did not go lower than it did in view of the immense sales of war materials which we were making to

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England without importing any considerable amount of merchandise in exchange. Exports seemed powerless to depress the rate. The explanation given was that the British Government "pegged" the rate at a certain point (4.75). This was true, but the British Government exercised no magic influence over the rates. A good part of the stabilizing of rates was done by security movements. At the outbreak of the war the British Government took over from its citizens hundreds of millions of dollars worth of American stocks and bonds which had been accumulated in the years when England was a heavy investor in America. As exports from America tended to depress the price of sterling, the British Government offset this action by sales of securities in the New York market.

New Issues of Securities

The placing of a new issue of securities in a foreign market has the same effect as the transfer of securities of an outstanding issue. Suppose the British Government floats a new issue of its own bonds in the American market as it did on two or three occasions during the war period. Either the proceeds of the loan will be spent in the United States or the amount will be transferred to England. If the latter procedure is followed the Amer-

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ican syndicate will be obliged to buy sterling drafts in the local market and remit abroad, or the British Government will draw drafts in dollars upon the syndicate and sell them in the London market, thus bolstering up the pound and depressing the dollar.

If, on the other hand, the proceeds of the loan are spent in the United States, the effect on exchange is not so readily noticeable but it is nevertheless the same as it would have been had the proceeds been transferred. Suppose England makes purchases in America amounting to \$15,000,000. Under ordinary conditions these purchases would bring into the market sterling drafts to an equivalent amount, and the tendency would be for sterling to fall. If, however, these purchases are paid for out of dollars already credited to England from the proceeds of a bond issue, no sterling bills need be drawn. In other words the exports will be offset by the proceeds of the loan, no sterling bills will be offered in the market, the supply of sterling will be short, and the market for sterling in New York will be higher than it would have been had no loans been made. The ordinary demands for exchange will continue as usual and they will have to be met out of the proceeds of exports other than the ones paid for by the dollars raised by the bond issue.

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Interest and dividend payments are important as affecting foreign exchange. Consider, for example, the effect of interest payments on the French Government 7½ per cent bonds, due each June and December. The semi-annual requirements on the whole issue, without making allowances for reductions by operation of the sinking fund, are \$3,750,000. This means that the French Government must buy and accumulate dollar exchange in New York to this amount every six months. The French Government, of course, gets its revenues in francs. Therefore, it will have to sell francs and buy dollars. The franc will tend to go down in New York and the dollar will tend to go up in Paris. Of course, the whole operation does not take place at once for it would too violently affect the market. It is spread out over a period of time so that its effect at any given time is hardly noticeable, but in the course of a year the effect on franc exchange is the same as though Americans exported to France an amount of goods equivalent in value to the interest due on these bonds.

The Effect of Short-Term Loans

Short-term loans are constantly being made between the bankers of any two countries and these affect the exchange market

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just as do bond issues. If bankers in America borrow in England they usually draw sterling drafts and sell them in the local market. The effect, of course, is to depress the price of sterling. Later on, the loan has to be paid and the borrowers go into the market and purchase sterling to remit abroad. This makes sterling rise.

A Stabilizing Device

This device of bankers' loans is particularly useful in reducing to a minimum the seasonal fluctuations of exchange rates. We have already noted that, in normal times, sterling is usually high in New York in the spring and low in the fall, due to the seasonal character of our exports of the great farm staples. In the spring sterling bills are relatively scarce and the banker finds that it is a relatively costly process to buy the bills needed to build up balances in London. In the fall, however, bills will be plentiful and balances can be built up more cheaply. It will, therefore, be good business to borrow sterling in London, sell it in New York at current rates, pay interest on the amount at current rates, and purchase in the fall the wherewithal to pay back the loan at the lower rate prevailing.

This procedure has much the same effect as future sales in the grain or cotton market.

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An artificial supply of exchange is created in times of shortage and this in turn is followed by an artificial demand in times of heavy supply. Rates go neither so high nor so low as they otherwise would, and the competition of many bankers tends to cut down the swing, so that rates are at a point which will just permit of carrying the necessary loans.

Other Items Affecting the Market

Other items affecting the exchange market are freight and insurance and bankers' commissions. In recent years the insurance business has become international. The names of many English and German insurance companies are household words in America. On the other hand American life insurance is known the world over. The insurance business keeps a steady stream of international remittances in the foreign exchange markets of the world, to pay premiums and losses. Premiums and losses paid to us raise our exchange rates in the markets of the world, and those we pay depress our rates. Generally these payments are steady throughout the year, but there are times when payments on account of insurance may dominate the market, as was the case, for example, after the Baltimore fire or the San Francisco earthquake.

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Freights and Commissions

Ocean freights and bankers' commissions on international transactions run well into the millions of dollars. If a country has a flourishing merchant marine and banking system, ramifying into every part of the world, the earnings of these enterprises must be added to the country's exports as an item tending to keep the country's exchange high in foreign markets. These items seldom appear separately, but they are added to each individual transaction and so swell the total due a given country, for which remittances must be made. In other words, a country may be an exporter or an importer of services, just the same as she may import or export merchandise, and these have to be settled for in the same way as does merchandise. In the past these items have been especially important in the cases of Great Britain and, to a less extent, of Germany.

Among the elements that bring foreign exchange into being are also the expenses of tourists and those of immigrants to the home country. Each summer before the war the expenses of Americans visiting Europe were enormous. Of course foreign exchange had to be bought by them or for them in the American market. The result was an appreciation of foreign exchange in New York

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and a depreciation in rates of dollars abroad. Small as this item may seem as compared with foreign trade, it is nevertheless true that it went far toward supporting the exchange of such a country as Switzerland in the foreign markets.

Influence of Gold Movements

Last of all the factors affecting the exchange rates are gold movements. When gold is exported from the United States to England, for example, it is converted into pounds sterling at the English mint and credited to the American shipper. An export of gold creates a balance abroad against which foreign drafts are drawn and sold. The effect is to increase the supply of exchange or to relieve the buying pressure on bills in the local market and consequently to depress rates. Gold imports have just the opposite effect. They tend to raise the rates of the shipping country in the local market and to depress the rates of the receiving country. Reversing the transaction and viewing it from the American standpoint, all the gold we receive tends to lower the quotations for dollars abroad, and all the gold we export tends to raise them.

Before the war, writers on foreign exchange laid a great deal of emphasis upon gold movements as correctives for rising or

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falling exchanges. The chief trading countries were then on a gold basis and gold was free to move from country to country as circumstances required. Only by appreciating the reasoning which applied to conditions then prevailing can we understand the more complex situation of the present time.

Gold Movements in Pre-War Times

Using the United States and England as an example, the reasoning was as follows: in the United States gold can always be obtained at the Treasury at the rate of 23.22 grains to the dollar. That is the metallic content of the dollar, and so long as the government keeps its promise to redeem its paper money in gold, there is no question that \$1 will be the cost of 23.22 grains of gold.

Now in England gold can always be sold at the rate of 113.002 grains to the pound sterling. That is Great Britain's legal coinage ratio and the mint is obliged to furnish pounds sterling at this rate to all who present gold for coinage.

To Build Sterling Balances

Assuming free movements of gold, an American who desires to build up sterling balances in London will have two alternatives. He may purchase sterling bills at the

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market rate in New York and remit them to his creditor, or he may purchase gold instead, and ship it. Sterling balances built up in gold will cost him \$4.8665 per pound ($1113.002 \div 23.22$) plus the cost of getting the gold to London. This cost we will assume to be approximately .0335 cents per pound sterling. Under these conditions balances can always be built up in gold in London at the rate of \$4.90 per pound sterling.

Bidding Up to \$4.90

Up to \$4.90, therefore, it will be more profitable to make payment in England by means of sterling bills bought in New York than to ship gold. Suppose, however, as was the case occasionally in the normal pre-war days, that sterling bills are scarce in New York. We will say it is spring and the cotton and grain bills of the autumn are not yet on the market, but there is a keen demand for sterling to pay for imports from England. Exchange dealers will bid up to \$4.90 for the comparatively few bills in the market.

Beyond that point no dealer could afford to bid. Rather he will ship the gold and sell drafts against the balance built up. A few shipments relieve the pressure on the market and the rate falls to a point where it is again more profitable to buy bills than to ship metal.

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The point at which it becomes more profitable for American debtors to make payments by buying gold in this country and paying the expense of shipping it abroad, than to buy and transmit bills, is spoken of as the "gold export point." Assuming that America has enough gold and that gold movements from this country to other countries are unrestricted, these movements will prevent exchange rates from rising beyond the gold export point.

Gold Import Point

Conversely there is a "gold import point" for each exchange rate below which the ratio is prevented from falling by the importation of gold from abroad, provided foreign countries have gold to spare and impose no restrictions on its outward movement. It is because these conditions do not prevail just at present, so that importations of gold do not occur as usual, that foreign exchange rates have proved to have no definite "bottom." The significance of the gold import point will now be briefly discussed.

For sterling exchange the gold import point is the mint par \$4.8665 less the cost of shipping (freight, abrasion, loss of interest for the time of transit, insurance, etc.) or about \$4.8365 per pound sterling. In normal times, those having sterling bills

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to sell in New York will take no less than this price, for they can have English coins shipped to them which, when presented at the United States mint, will net them \$4.8365 for every pound sterling.

Theory of the Gold Points

This is *the theory of the gold points*, a basic element in the explanation of how the rates of exchange of different countries are kept in line with one another when their monetary and credit systems rest on the firm basis of the gold standard. At the present time, however, as we have already stated, the theory is subject to great reservations, because the conditions necessary to proper working of the principle do not prevail so fully as they did before the war.

The gold points fix the limits for exchange fluctuations only (1) when gold movements are freely permitted and (2) when the country whose exchange is low has the gold to export. If these two conditions had obtained, sterling exchange would never have risen to \$7.00 in the New York market, as it did in August, 1914, nor would it have fallen to so low a point as \$3.20, as it did during the war and post-war period. Rather it would have fluctuated about the figure of \$4.8665, certainly between the points \$4.90 and \$4.8365. Nor would the German mark

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(gold par, 23.8 cents) ever have been quoted in New York at less than thirty one-hundredths of a cent to the mark, as recently happened, nor would the French franc (gold par, 19.3 cents) have sold at the post-war rate of 7.85 cents per franc.

Under normal conditions, long before the rates fell to these low points, we should have received a flow of gold from these countries which would soon have brought their exchanges up to the gold import point. But the necessary amount of gold did not come, for the reason that these countries owed us so heavily that any attempt to settle the balance in gold would have deprived them of that necessary volume of gold reserves required to prevent their monetary systems from undergoing complete collapse. These countries consequently imposed embargoes on the export of gold, for reasons already alluded to in our earlier discussion of the principle of reciprocity.

Summary

We may now summarize the items which affect the foreign exchange rates of a country. All of them, except those relating to exports and imports of gold, are as fully operative at present as they ever were, and even the gold movements are far from being without their significance. The great

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volume of depreciated currency now outstanding in so many countries introduces a special element into the market situation of which we must take account at a later point in this study, but the significance of this element can be appreciated only by relating it to the other factors affecting the market. We may properly bring together the factors involved by arranging them as follows:

Factors which hold up the value of dollar exchange

1. Exports of merchandise from the United States
2. Exports of gold
3. Interest and dividends paid to the United States
4. Sales of American securities abroad.
5. Foreign loans made to us
6. Expenses of foreign visitors in the United States
7. Earnings of our ships, insurance companies, banks, etc.

Factors which depress the value of dollar exchange

1. Imports of merchandise into this country
2. Imports of gold
3. Interest and dividends paid foreigners
4. Sales of foreign securities in this market

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5. Loans made by us
6. Expenses of American tourists abroad
7. Remittance of immigrants from the United States to home countries
8. Freight, insurance, commissions, etc., paid to foreigners.

These items cannot always be measured in actual dollars and cents, but they are always operating in the exchange market. Those enumerated in the first section of the above list are always boosting the value of the dollar in foreign markets; those named in the latter section tend to pull it down. When the two sections are equal, exchange is in equilibrium. The demand equals the supply, and exchange will be about at par. In normal times this is what happens. The outgo equals the income. There are temporary fluctuations, it is true, but rates fluctuate about the par of exchange.

The foregoing is true because economic forces are constantly working to restore equilibrium. When the exchange rates of a country fall, influences are set in motion which check the fall and cause a rise. If rates go up, the inevitable result is the setting in motion of forces that sooner or later bring the rates down. Let us now consider how this happens, beginning with a discussion of how high rates of exchange tend to

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correct themselves. We may use the exchange rates of this country as an illustration of the points we are to consider, for the United States today furnishes the best example of a country whose exchange rates are high in all foreign markets.

V

Fluctuations in Rates of Exchange

One effect of high exchange rates is that gold is attracted to the country whose rates are high. It is cheaper to create exchange in that market by shipping gold than by accumulating bills of exchange at the current market rates. In spite of hampering influences on the flow of gold, this is just what has been happening recently in the United States. In the first seven months of 1921, gold to the value of \$410,562,000 came in. Gold came to the United States from Sweden, for example, in the early part of 1921. Dollars have been quoted in Stockholm at the rate of about 4.75 kroner. That is, in the foreign exchange markets of Sweden one who desires to purchase a draft for remittance to America has to pay $4\frac{3}{4}$ kroner to the dollar for it. But the mint parity of kroner is about 3.73 to the dollar.

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That is, to purchase gold at the mint rate in Sweden and send it to the United States requires only about $3\frac{3}{4}$ kroner to the dollar. Hence the flow of gold from Sweden.

Gold Imports and Trade

Now we learned in our study of the subject of money and banking that when gold flows into a country its prices are likely to become inflated. That country becomes a dear country to buy in. Foreign customers must pay both the inflated prices and also a premium on the exchange. Inevitably the exports of the country whose exchange rates are high show a falling off. And we have already seen that a falling off of a country's exports is an influence for lowering its exchange rates. Exports have been falling off in the United States and would have declined still more except for the fact that the articles we have been exporting have been in large part foodstuffs which foreign countries cannot do without and which they cannot procure elsewhere. On the other hand it is certain that they are not now buying luxuries and semi-luxuries, or even as much raw material as they otherwise would.

A Good Country to Sell In

A country whose exchange rates are high is conversely a good market for a foreign

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country to sell in. Not only are prices usually high in that country but the foreign seller obtains also the benefit of a premium on the exchange. Imports therefore, tend to flow into a country whose exchange is high. The effect of increased imports, as we have noted, is to lower the exchange rates of the importing country.

Here again, as in the case of exports, we have to qualify the principle as it operated under post-war conditions. With dollars at the premiums we have mentioned, the normal expectation would be a flood of foreign goods into the United States. As a matter of fact no such flood has come. This has largely been due to the paralysis of the productive equipment of Europe and to the necessity which Europe is under of purchasing high-priced raw materials abroad before she can manufacture.

A Good Country to Borrow In

Not only is a country with high exchange rates a good country for foreigners to sell in, but it is also a good market to borrow in. We have seen a great deal of borrowing by foreign countries in the United States during and since the war, all of which has given rise to a supply of "dollars" and tended to reduce the premium on the latter. Since the war we have also seen foreign holdings

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of American securities constantly dwindling. On December 31, 1914, for example, the United States Steel Corporation reported 1,193,064 shares of its common stock held abroad. In 1916 this figure had fallen to 502,632, in 1919 it was 368,895, in 1920, 292,835, and on December 31, 1921, it totalled only 280,026 shares. Other securities held abroad have shown the same trend. A considerable supply of "dollars" has therefore come from this source, tending to reduce the premium on the dollar.

The inevitable tendency is for the exchange of a country that is high to return to normal. High exchange rates attract imports of merchandise and securities; they cause borrowers to seek out that market for their loans; and they cause a fall in exports. All these tend to eliminate the high rates of exchange. High rates of exchange, as we have stated before, tend to eliminate themselves.

The Tendency of Low Rates

Low rates of exchange also tend to eliminate themselves, because a country whose exchange is low has its business affairs affected in ways exactly opposite to those resulting from high exchange. Its exports will be stimulated, for in selling abroad its merchants and traders have the advantage of

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the premiums quoted on foreign currencies. This is illustrated by the case of Germany. Because of the low value of the mark a German manufacturer has been quoted as saying that he could sell at pre-war prices in foreign countries (figuring those prices in terms of the currencies of the buying countries) and with the currency received in payment, buy at home enough marks to pay very satisfactory wages and yet retain a large profit for himself. This explains why in July, 1921, a German firm obtained an order for 10,000 steel wheels in Argentina at 50 gold pesos per wheel while quotations from American and British manufacturers ranged from 70 to 118 gold pesos per wheel.

In a similar manner, if a country's exchange is low it is to that country's advantage to sell securities abroad, to curtail its own imports, to borrow in foreign markets, and to export gold if that is possible. The inevitable tendency is for its exchange to correct itself.

The Course of Canadian Exchange

The rise and fall of exchange rates as the result of unbalanced trade has been illustrated in recent years by the state of the exchanges between the United States and Canada. They are of especial interest be-

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cause there is no reason to believe that they were affected by currency inflation. Credit inflation existed in Canada, but probably to no greater extent than in the United States.

During the early years of the war, the trade balance was heavily in favor of the United States, for several years exceeding \$300,000,000 annually, an amount greater than the total banking reserves of Canada. Under normal conditions Canada would have been able to use her credit balances against other countries, and especially those against Great Britain, to settle her debt to this country, but as her creditors had established gold embargoes, Canada found it necessary to do the same.

Embargo Creates Competitive Situation

Soon after the embargo went on, Canadians having payments to make in the United States found it difficult to obtain drafts for the purpose. The Canadian banks found it impossible by ordinary means to maintain balances in the United States against which they could draw, for the regular exports to this country were insufficient to create them. A competitive situation developed, in which parties who were exporting products to the United States were able to sell the credits thus created at a premium. The premium was small at first but by the fall of 1918 it

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had risen to 2 per cent, by the spring of 1919 to 4 per cent, by the fall of 1919 to 6 per cent and continued upward from this point to 18 per cent. The premium became an open offer or inducement to anyone able to create credits in the United States to do so. They could be created in various ways: by the shipment of products, by the sale of securities, or by direct borrowing. Canadian paper and pulp mills selling their products in the United States, found the premium upon their drafts an important new source of income. Wheat poured over the border in quantities which stimulated a demand in this country for a protective customs tariff, and the movement of other products was affected in like manner. Canadian loans aggregating very large sums were negotiated in this country in behalf of the Dominion government, provincial and municipal governments, railroad companies, and other corporations and individuals. If the borrowers had no payments to make in the United States, they still could use the funds here advantageously by selling them at a premium to other Canadians.

Natural Influences Restore Balance

All of these influences, set in motion by the unbalanced state of the exchanges, tended to reduce the discount upon Canadian

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exchange in the United States and the premium upon United States exchange in Canada, thus bringing these back into balance again. A premium existed upon exports from Canada to the United States and a penalty was imposed upon imports from the United States into Canada. Manufacturers and jobbers in the United States found it increasingly difficult to hold their Canadian customers; shopping in the United States became increasingly expensive for Canadian consumers; but Canadian producers found it increasingly advantageous to sell in the United States, until gradually under the combined strength of these influences, the difference in the exchange rates gradually diminished until it has almost disappeared.

It should be observed that the question of Canadian credit was not involved, nor was the discount of Canadian exchange due to any hostility or manipulation in the United States; in fact, it was caused by competition among Canadians for means of making payments in the United States, and the effects were decidedly harmful to business men of the United States engaged in exporting to Canada. The experience clearly illustrates the futility of trying to build up a great one-sided trade. But for the enormous borrowings of Canadians in the United States, the premium on United States exchange in

the 'information' and 'communication' fields, and the 'information science' field.

It is important to note that the 'information science' field is not a new field, but a field that has been developing since the 1960s.

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